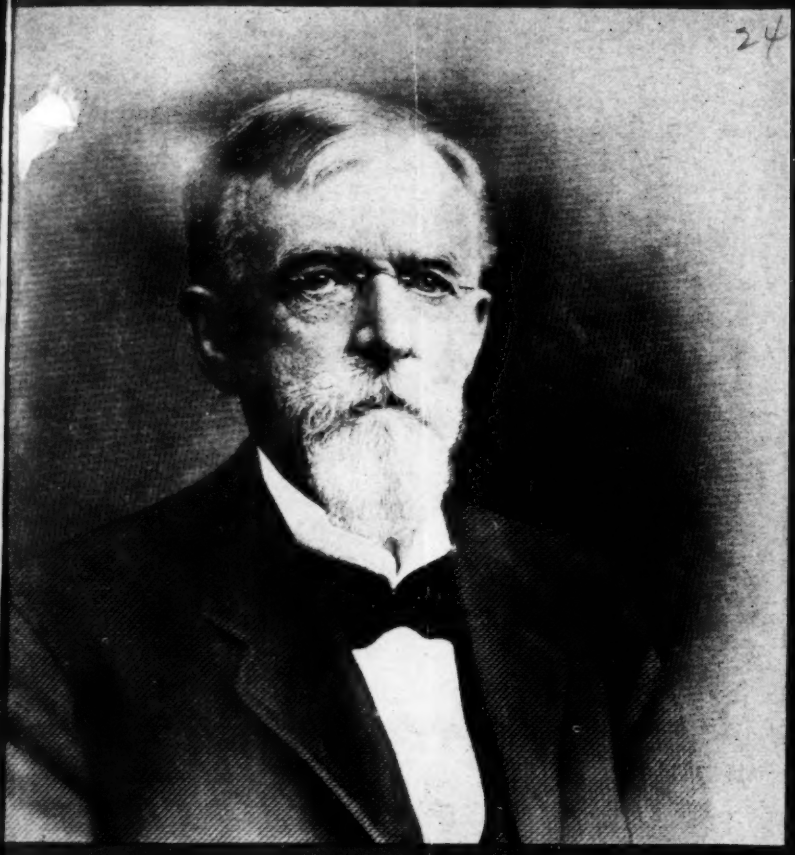

NOV. 1960

The Los Angeles BAR BULLETIN

VOL. 36 No. 1

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THE PRESIDENT'S PAGE

☆ ☆ ☆ ☆ ☆ ☆ ☆ ☆ GRANT B. COOPER

» » MEMBERS OF THE Los Angeles County Bar Association are to be complimented warmly, I feel, on their very creditable degree of participation in the annual meetings, as well as the committee work, of the various professional organizations to which so many of them belong.

These include the American Bar Association, National Conference of Bar Presidents, American College of Trial Lawyers, State Bar of California, and numerous other law groups.

The participation has been greater and more general this year than ever before, according to informal inquiries and observations I have made in recent weeks. This participation has certainly done nothing, I am confident, to detract from the prestige nationally and regionally of the lawyers and jurists of this area.

Those who have participated in these meetings need no assurance of the value and merit of their investment in time and money in these corollary activities to which attorneys and jurists are warmly welcomed.

I think it is safe to say that such participation in these gatherings of the most active and dedicated members of our profession makes an attorney a better lawyer and a more-orientated citizen because it sharpens his awareness of trends and conditions affecting the society we seek to serve in these changing times. It helps to keep him abreast, also, of shifts in economics, political conditions and public opinion which have an effect on his economic as well as professional standing and well-being.

Just as in our own association programming, every effort is made to obtain the appearance of the finest speakers, the ranking authorities and the most distinguished leaders in the fields in which we are interested for these annual meetings. Consequently those who attend such sessions enjoy the privilege of seeing and hearing men in the full flower of their intellectual prowess speaking on topics on which they are the acknowledged authorities. This is a privilege well worth making unusual, even extraordinary, effort to experience.

(And there is the added advantage that attendance at such meetings is a legal and proper tax-deductible business-professional expense.)

A mere scanning of the program topics of almost any convention of our professional groups serves to indicate the wealth of information available to those who take the time and trouble

to expose themselves to it by attending.

At the 83rd annual meeting of the American Bar Association in Washington, D.C., there were addresses and panel discussions on such diverse subjects as law office management, electronic data retrieval, crime portrayal in the public media and its effects on fair trial, developments in domestic relations and family law, the "economic anemia of the legal profession in America—and what Illinois is doing about it," use of visual aids in court, growing pains of the smaller cities and their attendant problems – traffic, water, taxation; urban renewal, patents and copyrights, international legal cooperation, insurance in relation to such new hazards as radiation injuries, problems of the legal profession in an era of big government, and even the legal implications of "how high is up?" —a problem now being classified as space law.

Besides the boon of being able to hear and participate in these subjects through attendance in person, there is another dividend in attendance at our periodic meetings.

This is through being handed copies of the scripts used by some of the speakers, as well as copies of exhibits used to illustrate the talks. Many convention delegates have added importantly to their office reference material by making it a point to accept or to seek these scripts at the meetings they have attended.

To a certain degree this policy of availing one's self of this knowledge and information is as sensible as learning to read and of patronizing the library from an early age. One is able to tap the accumulated knowledge and experience of those who preceded us and groped their way upward toward the light and have left us a rich legacy which is ours merely through claiming it.

It should be a matter of pride and reassurance to the legal profession in this area, as it is to me, to observe that Los Angeles lawyers and judges have taken and are taking so active a part in the meetings, conferences and deliberations of the bench and bar of the United States. It is my hope and belief that this trend will continue. It cannot but help improve the awareness and competence of the profession so that it will even better serve society.

THIS MONTH'S COVER

Last month's cover showed Andrew Glassell, IV, who in 1878 became the first President of the Los Angeles Bar Association. The Association faded out of existence in the early 1880's and was not reactivated until 1888. John D. Bicknell, who is featured on this month's cover, was most active in this rebirth of the Association. He became its Vice President in 1888 and President in 1890.

Tall, slender, white-bearded John D. Bicknell arrived in California in 1872 and became a leading member of the business community and the legal profession in Los Angeles. He was attorney for the Southern Pacific and later the first President of Abstract and Title Insurance Company, the first corporation in Los Angeles to issue abstracts and certificates of title. This company was later consolidated with the Los Angeles Abstract Company into a new corporation, Title Insurance and Trust Company.

Deductibility of Attorneys' Fees Incurred For Divorce, Alimony and Property Settlement Agreements; How the California Attorney Can Best Obtain Maximum Deduction for His Client.

By Donald W. Crocker

Third Prize Winner
1960 Justice Ashburn Junior
Barristers' Essay Contest

» » IN THE UNITED STATES approximately one in every four marriages ends in legal separation or divorce. Even in cases where the divorce or separation action is uncontested, substantial legal fees and related costs are often incurred because of the difficulty in negotiating and drafting a property settlement agreement acceptable to both parties. The attorney representing a party to a divorce or separation action will often be asked by his client if any portion of his bill for fees and costs is deductible for Federal income tax purposes. The purpose of this paper is to aid the attorney in answering this difficult question.

In advising the client as to which legal expenses incurred in connection with a divorce are deductible the first step should be the separation of the total amount expended into four general categories, namely, (1) expenses related to obtaining the divorce order, (2) expenses with respect to alimony, (3) expenses in reaching the property settlement agreement, and (4) expenses for advice regarding the tax effect of the divorce and property division and the filing of tax returns during the interlocutory period and after the divorce. Such an allocation will make it easier to answer the client's questions, since different rules are applied to each category. Allocation is also required by the Treasury before the taxpayer will be allowed to deduct any portion of his expenses.[1] The deductibility of each category of expenses will now be discussed in the order stated above.

1. Expenses incurred in obtaining the actual Divorce or separation.

No portion of either the husband's or wife's expenses incurred in connection with obtaining the divorce or separation order will be deductible.[2] This rule also applies to expenses incurred in reaching an agreement or obtaining an order for custody of minor children.[3] These expenses are

[1]Regs Sec. 1.265-1; *Harriet C. Flowers v. Comm*, DC, W.D. Pa., 57-1 USTC Par. 9655 (1957).
[2]*Howard v. Comm*, 202 F. 2d 28 (9th Cir. 1953), aff'g 16 TC 157 (1951); TD 5889 (CB 1952-1, 31).
[3]*Baer v. Comm*, 196 F. 2d 646 (8th Cir. 1952), aff'g and rev'g 16 TC 1418 (1951).

Mr. Crocker is a native of Pasadena, California. He received the B.A. degree from Stanford University in 1956, and the LL.B. degree from Stanford Law School in 1958. He is presently associated with Harry M. Halstead in Los Angeles.

uniformly held to be nondeductible personal or family expenses.[4]

2. Expenses in connection with alimony.

The attorney for the wife should advise her that she may deduct that portion of her legal expenses allocable to obtaining an agreement or court order requiring her husband to pay her alimony, if said alimony will be taxable to her under section 71[5] of the Internal Revenue Code.[6] The Treasury has given its express approval to such deduction where the wife has made proper allocation of her legal expenses between this and other services rendered by her attorney and has actually paid these legal expenses herself.[7]

Unfortunately the attorney for the husband must explain to him that his legal expenses incurred in resisting his wife's demands for alimony are generally not deductible.[8] This is true even where the husband has been successful in reducing the amount of alimony he is required to pay his wife and has thereby increased his taxable income.[9] The courts which have ruled on this problem[10] and denied husband's deduction have based their decisions on several grounds. The ground most often relied on is that such expenses are incurred as a direct result of the failure of the taxpayer's marriage and are therefore nondeductible personal expenses.[11] A second ground used by some courts[12] is that the Code permits the deduction of only those non-trade or non-business expenses which are incurred to produce income, and the expense in question is not incurred to produce income but to relieve taxpayer of a threatened or actual liability, which is a nondeductible expense.[13]

In spite of the weight of authority, in 1953 the 8th Circuit in BAER V. COMM.[14] recognized a limited exception to the above rule of nondeductibility and held the husband could deduct his legal expenses in contesting his wife's alimony claims to the extent that (1) they were for settling a controversy between the spouses which involved not whether, or in what amount, husband was liable to

[4]Notes 2 and 3, *supra;* Crimball, "Deductibility of Fees and Expenses in Connection With Separation or Divorce," Proc. NYU 15th Ann. Inst. on Fed. Taxation 787 (1957).

[5]1 RC Sec. 71 provides that "periodic payments" of support to a divorced or legally separated wife are includible in the income of the wife and deductible by the husband.

[6]Regs Sec. 1.262-1(b)(7); *Davenport v. Comm,* 12 TCM 858 (1953).

[7]The wife must pay the expense herself in order to be allowed a deduction. If her expenses are paid by her husband, even though pursuant to court order, no deduction will be allowed either the husband or the wife. *Lewis v. Comm,* 253 F. 2d 821 (2d Cir. 1958); aff'g 27 TC 158 (1956); F. Ewing Glasgow, 21 TC 211 (1953). Grimball, Note 4, *supra,* at p. 792.

[8]Notes 4 and 6 *supra.*

[9]*R. Fenley Hunter v. U.S.,* 219 F. 2d 69 (2d Cir. 1955), aff'g 123 Fed. Supp. 763 (F.D. N.Y. 1954).

[10]The Tax Court in *Howard v. Comm,* 16 TC 157 (1951), in discussing whether the husband could deduct his legal expenses in resisting his wife's alimony claims stated: "It may seem strange that we find no decided case squarely in point. Perhaps this is because the answer seems so obvious that no one has heretofore raised the issue. Be that as it may, we find no basis for petitioner's contention and accordingly affirm respondent's disallowance of the legal expenses incident to the [suit for alimony]." At p. 162.

[11]Note 2, *supra; Est. James Walsh v. Comm,* 28 TC 1274 (1957); *Andrew Jergens v. Comm,* 17 TC 806 (1951).

[12]In R. Fenley Hunter, Note 9, *supra,* the 2nd Cir. held: "We think the 'production' of income means the creation of increased gross income, not a reduction of liabilities or an increase of net taxable income by a reduction of allowable deductions in computing net income." At p. 70, citing *Lykes v. U.S.,* 343 US 118 (1952), and *Howard v. Comm,* Note 2, *supra.*

[13]Regs Sec. 1.262(m); *Lykes v. U.S.,* note 12, *supra.*

[14]*Baer v. Comm,* Note 3, *supra.*

his wife for support,[15] but the manner in which such liability should be satisfied, and (2) wife's demands regarding how husband's liability should be met threatened husband's continued control over income-producing property important to his general capacity and ability to earn income. The above stated test for deductibility would be met in a situation where the wife demands that her husband discharge his obligation to support her after divorce by either a lump sum payment or several large instalment payments over a relatively short period of time,[16] and the expenses sought to be deducted by husband are incurred in working out a method of discharging his obligation in a way which will not force him to liquidate his interest in a business from which he derives most of his income through salary and/or dividends.

The Treasury has not yet recognized any exception to the rule that husband's expenses in contesting wife's alimony claims are not deductible,[17] but the courts now uniformly recognize the existence of a limited exception[18] where the taxpayer's factual situation meets the test stated by the 8th Circuit in BAER v. COMMISSIONER. Therefore, if the husband's particular factual situation is arguably within the exception stated by the Circuit Court in BAER v. COMM., and he is willing to litigate[19] the question of the deductibility of his expenses, his attorney should advise him that he has some chance of success.[20]

3. Expenses in reaching a property settlement agreement.

In many instances the major portion of the attorney's fees in dissolving a marriage are allocable to time spent in negotiating and preparing the property settlement agreement between the spouses. In the case of a client of substantial means it is not uncommon for an attorney to charge in excess of $5000[21] for such services. Therefore it will be very important to the client whether any portion of his property settlement expenses will be deductible for Federal income tax purposes. The pertinent Code sections, the Treasury regulations and the many conflicting court decisions which bear on this question must first be discussed in some detail before any conclusion can be tendered as to what property settlement expenses will be deductible, and the best course for the California attorney to follow to insure for his client the maximum deduction.

The only section of the Internal Revenue Code which authorizes deduction by an individual taxpayer of

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[15]Distinction is made between husband's support obligation to his wife on divorce, and the rights of the divorced wife under the applicable State law to marital property. The deductibility of fees incurred in connection with contesting wife's claims to the latter are discussed under paragraph 3.

[16]The test for deductibility defined in the Baer case is applicable only where wife's claim for support, if allowed, would force husband to liquidate his income producing property. It is impossible to conceive of this test being met with respect to support rights except when a lump sum or large instalment settlement is sought.

[17]TD 5889 (CB 1952-1, 31).

[18]*Howard v. Comm*, Note 2, *supra*. *Bowers v. Comm*, 243 F. 2d 904 (6th Cir. 1957), rev'g 25 TC 452 (1955); *McMurtry v. U.S.*, 132 Ct. Cls. 418, 132 Fed. Supp. 114 (1955); *Cf Lewis v. Comm*, 253 F. 2d 821 (2d Cir. 1958), aff'g 27 TC 158 (1956) in which the majority of the Court stated that it declined to follow Baer but the dissent felt that Baer was merely distinguishable on its facts.

[19]When the Treasury disallows taxpayer's deduction the taxpayer can litigate the Treasury's determination in the Tax Court or he can pay the tax assessed and sue for refund in either the Court of Claims or the U.S. District Court.

[20]Since the Tax Court has national jurisdiction it is not bound by Circuit Court decisions reversing it. Arthur L. Lawrence, 27 TC 713, rev. on other grds., 9th Cir., 58-2 USTC Par. 9648 (1958). Therefore the Tax Court decision in Baer, which denied any deduction of husband's expense, is still the rule in the Tax Court. It is suggested that any action be brought in the District Court or Court of Claims since these courts have no adverse precedent and are more likely to be sympathetic to the taxpayer's position.

[21]See *Baer v. Comm*, Note 3, *supra* ($16,500); *Patrick et al v. U.S.*, DC. W.D. S.C., 60-2 USTC Par. 9559 (1960) ($16,000); *Owens, et ux v. Comm*, 273 F. 2d 251 (1960) rev'g 17 TCM 519 (1958) ($7500).

non-trade or non-business expenses is section 212,[22] so if legal fees for a property settlement are to be deductible they must come within the provisions of this section. Section 212 provides that a non-trade or non-business expense is deductible only if it is ordinary and necessary[23] and paid or incurred[24] during the taxable year (1) for the production or collection of income,[25] (2) for the management, conservation or maintenance[26] of property held for the production of income, or (3) in connection with the determination, collection or refund of any tax.[27] The first and second basis for deductibility will be dealt with below and the third will be considered in connection with expense category number 4.

Section 211 of the Code makes deductions which are allowed under section 212 subject to the exceptions set forth in Part IX of the Code. The exceptions pertinent to our subject are contained in section 262, which prohibits the deduction of "personal, living or family expenses"; section 263 which prohibits the deduction of capital expenditures to acquire title to property or improve or better the value of property; and section 265 which disallows any deduction in connection with managing, collecting or preserving tax exempt income.

Before attempting to decide the applicability of the exceptions the attorney should first determine what portion of the client's property settlement expenses were connected with either the production or collection of income, or the management or conservation of income-producing property, since section 212 allows the deduction of only those property settlement expenses which meet this requirement. For instance, it is clear that any property settlement expenses incurred in connection with settling and spouses' rights to such property as family automobiles, jewelry, silver, and the family residence do not come within the provisions of section 212 and will never be deductible.[28] However, the expenses of the spouses in settling their rights to investment and income-producing property and to unreported income do meet the requirements for deductibility stated in section 212.[29] The attorney should therefore advise his client to only claim a deduction[30] for the latter type of expenses. The

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[22]Until the addition of Sec. 23(a)(2) to the 1939 Code the courts held that only expenses connected with taxpayer's business were deductible. *U. S. v. Pyne*, 313 U.S. 127 (1941). Sec. 23(a)(2) allowed the deduction of non-trade or business expenses for the production of income and it was carried over as Sec. 212 in the 1954 Code, but with the addition of a Subsection (3); H Rept #2333, 77th Cong 1st Sess, p. 46.

[23]"Ordinary and necessary" is interpreted by the Treasury to require that the expenses be reasonable in amount and bear a reasonable and proximate relation to the production or collection of taxable income or to the management, conservation or maintenance of property held for the production of income. Regs Sec. 1.212-1(d).

[24]For the cash basis taxpayer the expense must be deducted in the year in which it is paid; for the accrual basis taxpayer the expense must be deducted in the year it is incurred regardless of the year of payment. Mertens, Law of Federal Taxation, Sec. 25.09.

[25]"Production and collection" are presumably to be given their dictionary connotations. See Regs Sec. 1.212-1(c); and Dohan, "Deductibility of Non-business Legal and Other Professional Expenses; Expenses for Creation or Protection of Income or Property, Divorce, etc.," Proc. NYU 17th Ann. Inst. on Fed. Taxation 579, at 582 (1959). "Income" is defined by the Regulations as "not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property." Regs Sec. 1.212-1(b); See Agnes P. Coke, 201 F. 2d 742 (5th Cir. 1953), aff'g. 17 TC 403 (1951), Acq. 1953-2 CB, 3 holding that capital gains are "income."

[26]The Regulations do not define the meaning of this phrase but the Supreme Court has given it a broad and literal meaning. Trust Under the Will of *Bingham v. Comm*, 325 U.S. 365 (1945).

[27]This provision was added in the 1954 Code to overcome the holding of the Supreme Court in *Lykes v. U.S.*, Note 12, *supra*, that no deduction is allowed for expenses incurred in resisting an asserted gift tax deficiency.

[28]Note 4, *supra;* Charlotte M. Douglas, 33 TC 349 (1960).

[29]*Baer v. Comm*, Note 3, *supra; Owens, et ux v. Comm*, Note 21, *supra.*

[30]Taxpayer must itemize his expenses in order to deduct expenses allowed under Sec. 212.

taxpayer should be advised to support said deduction with a schedule showing a detailed allocation of the total property settlement expenses between the costs of settling property rights to income and income-producing property and the costs of settling property rights to other property, and the basis used for said allocation.[31] If he fails to do so his right to any deduction may be seriously prejudiced.[32]

As previously mentioned, a deduction allowed under section 212 is subject to the exceptions stated in Code sections 262, 263 and 265. Therefore, the essential question is: to what extent do Code sections 262, 263 and 265 limit the deduction of property settlement expenses which otherwise meet the requirements for deductibility provided in section 212? Unfortunately there is no clear answer. It is currently the Treasury's position that the personal expenses and capital expenditure exceptions prohibit any deduction of property settlement expenses. The Tax Court has generally followed the Treasury's position. However, the District Courts, Court of Claims, and Circuit Courts have developed their own interpretation of the relationship of these sections and recognize an important exception to the Treasury's rule of nondeductibility. Each of the above mentioned exception provisions will now be discussed and the approach which offers the taxpayer the best chance of success in avoiding their application will be noted.

(a) *Section 262—Personal and family expenses.*

The underlying cause of all expenses incurred in connection with divorce or separation is undeniably the domestic difficulties of the spouses. Since section 262 forbids the deduction of personal or family expenses the Treasury takes the position that generally expenses incident to divorce will not be deductible.[33] This is also the ground most often used by courts denying the deduction of property settlement expenses.[34] However, in BAER v. COMM.[35] the 8th Circuit held that in the situation where the wife's demands for property settlement threaten husband's control over income-producing property which is important to his ability to continue to earn income, that portion of the husband's expenses in working out how he can meet his wife's demands and still preserve his income-producing property[36] will be

(Continued on page 20)

[31]Harriet C. Flowers, Note 1, *supra;* The Court in *McMurtry v. U.S.*, Note 18 *supra,* suggested that in support of the amount of property settlement expenses deducted "it would be relevant to show the husband's total financial situation and income and the impact the wife's demands might have thereon; also to show approximately what proportion of the legal services were utilized in resisting his wife's demands against specific income-producing property and in protecting his tenure in a fees-paying corporate directorship, and to what extent these legal services were used for other phases of the case." At p. 421-2.

[32]Cases disallowing taxpayer any deduction on the express grounds that there had been insufficient allocation of expenses include *Richardson v. Comm,* 214 F. 2d 248 (4th Cir. 1956), aff'g 14 TCM 941 (1955); *James E. Walsh v. Comm,* 28 TC 1274 (1957); *Tressler v. Comm,* 228 F. 2d 356 (9th Cir. 1956), aff'g 12 TCM 358 (1956). In the latter case the dissent stated that the case would have been decided in favor of the taxpayer if allocation had been made.

[33]Note 6, *supra.*

[34]*Howard v. Comm,* Note 2, *supra;* Charlotte M. Douglas, Note 28, *supra;* Dohan, Note 25, *supra,* at p. 598.

[35]Note 3, *supra.*

[36]In the Baer case the property involved was controlling stock in a closely held corporation which paid the taxpayer substantially all his income in the form of salary and dividends. Loss of controlling interest in the corporation would have resulted in the loss of salary and diminution of dividends. The Tax Court has construed the Baer case narrowly and therefore has held that to meet the test for deductibility it is not enough that the property involved be income-producing, it must have a special value to the taxpayer "aside from its normal or market value." Charlotte M. Douglas, Note 28, *supra.* Many courts have followed the Tax Court rule but others have indicated that the property need not have a special value as long as it is income producing. For example of the latter position, see *Simeon Aller v. Comm,* D.C., S.D. Calif., 56-2 USTC Par. 9867 (1956).

Charitable Contributions of Appreciated Property

By L. D. LAWRENCE

Member, Los Angeles Bar Association, Committee on Taxation

» » FOR SEVERAL YEARS it has been established through court decisions and Treasury Regulations that the fair market value of property contributed outright to a charitable organization by a taxpayer may be deducted by him for federal income tax purposes within the statutory limitations on charitable contribution deductions. Further, the Internal Revenue Service has ruled that such contribution, even though the property has appreciated in value over the taxpayer's cost, will not constitute a disposition of the property giving rise to taxable income or gain. [Rev. Rul. 55-138 (C.B. 1955-1, 223) and Treas. Regs. § 1.170-1(c)] Even where appreciated property is given to a charitable organization in satisfaction of a pledge to contribute a specific sum, no taxable gain is realized. The Service has held that it would be inconsistent to treat such a transfer of property to a charity as both a "contribution or gift" and also as satisfaction of a debt exceeding the basis of the property. [Rev. Rul. 55-410 (C.B. 1955-1, 297)]

It has also been ruled that a taxpayer who donates appreciated property to a charitable organization for the organization's agreement to pay him the income from the property, or from investments resulting from the proceeds of sale of the property sold by the charity, is entitled to deduct as a charitable contribution the present value of the remainder interest, and does not realize taxable income from such donation. [Rev. Rul. 55-275 (C.B. 1955-1, 295) and several private letter rulings.][1] By such a transaction a taxpayer could in effect convert his return from low-basis, relatively low-yield assets into a higher investment yield for his life without having to pick up any taxable gain.[2] In this case, however, there should be no guarantee of a fixed amount of income; the source of income receivable by the donor from the charitable organization should include only the income produced by the property or by the reinvestment of the proceeds of sale. Thus, although the "gain" realized on the principal sum by the organization from its sale of the property may be reinvested to produce income, such gain should not be directly repayable to the donor.

The above principles have also been considered applicable in the case of

[1]A national tax service has advised in a recent bulletin that the Internal Revenue Service is about to issue a ruling, reversing its previous rulings and holding that the donation of appreciated property to a charity in return for the latter's agreement to pay the donor income for his life, results in the realization of capital gain on the ground that the charitable organization is in effect acting as the donor's agent. Until this matter is clarified, use of the above arrangement should be avoided.

[2]Moreover, for federal estate tax purposes, although the property would be includable in the donor's gross estate when he dies, the effect of this would be completely offset by an equivalent charitable deduction. In addition, the inclusion of the property in the adjusted gross estate could operate to increase the base for the purpose of computing the potential marital deduction.

a "bargain sale" to a charitable organization. Thus, a taxpayer desiring to make a charitable contribution in an amount equal to a portion or all of his unrealized "paper" profit on a specific property, would sell the appreciated property to the charity at his cost or at some other figure less than its current market value. He is not considered as having realized any taxable income from the situation as described above, but the excess of market value over sales price is eligible for the contributions deduction.

In its recent decision in *Magnolia Development Corp.* (T.C. Memo 1960-177), the Tax Court, although it accepted – and the Government conceded–the proposition that a taxpayer is entitled to a deduction for the contribution of unrealized profits by means of a "bargain sale" to a charity, and does not thereby realize taxable income, points up the danger of selecting appreciated property against which the taxpayer has borrowed, as the property to be used in consummating the transaction with the charity.

In this case, just prior to the transaction with the charitable organization, the taxpayer negotiated a loan on its property, pledging the property as collateral; the assignment of the property to the organization was made subject to the taxpayer's loan. The Internal Revenue Service contended that the taxpayer had made a "sale or other disposition" of the property and had realized a capital gain based on the difference between the amount realized in its borrowing transaction and the cost basis to it of the property. The Tax Court upheld the Commissioner, regarding the taxpayer's "scheme" as a "route" serving no business purpose other than tax avoidance. Thus, it concluded that the contribution of the property subject to the indebtedness was in substance a sale or other disposition of the stock to the charitable institution for the amount of the indebtedness to which it was subject. In other words, the transaction was a sale of the property for a price equal to the difference between its fair market value and the amount of the intended gift.

In an earlier case, *Crane v. Commissioner,* 331 U.S. 1 (1947), involving the sale of property subject to a mortgage by a taxpayer-mortgagor who was not personally liable on the mortgage, the U. S. Supreme Court stated that a mortgagor not personally liable on a debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the "boot"–the additional consideration.

These two decisions and private rulings in this area, strongly suggest that a taxpayer who desires to contribute appreciated property to a charitable organization, whether by an outright gift assignment or a bargain sale, should be careful in using property subject to a debt.

Apart from the above caveat, the prospective donor, if he is dealing with property that has no readily determinable market value, should take steps to establish the fair market value of the property to be contributed or "sold." Otherwise he will be at a considerable disadvantage if the amount of his claimed deduction is subsequently questioned on audit. See *John M. Coulter et ux.,* 9 T.C.M. (C.C.H.) 248 (1950).

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Loyd Wright Jr. To Head Legion Lex

Loyd Wright, Jr., succeeds Samuel L. Kurland as president of Legion Lex, the University of Southern California School of Law supporting group.

Officers and directors for the coming year were introduced at Legion Lex's fourth annual black-tie dinner October 18, which was held in the Venetian Room of the Ambassador Hotel.

Other officers introduced were Arthur Freston, vice-president; Richard E. Davis, secretary; and Ashley Stewart Orr, treasurer.

Directors who will serve three-year terms are Arthur E. Pugh, Jr., William R. Jarnagin, and Max Frank Deutz. Serving two-year terms are Lee Combs, Roland Maxwell, Judge Aubrey N. Irwin, and Stanley Gleis. Serving one-year terms are Richard Kirtland, Edward S. Shattuck, Louis M. Brown, and Arthur D. Guy, Jr.

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deductible.[37] The rationale of this departure from the Treasury's position is that regardless of the underlying cause of the expense, the immediate cause is husband's concern to protect his future income, and the direct effect of his expense is to protect income-producing property.[38]

The holding of the 8th Circuit Court in BAER has been adopted by almost all of the courts as the correct statement of an exception to the general rule that property settlement expenses are nondeductible personal expenses.[39] It should be noted, however, that the Treasury's current position is that all deductions of expenses of property settlement will be disallowed. Therefore, if taxpayer desires to deduct such expenses he must litigate his right to do so in the courts. If the taxpayer does not wish to pay the additional tax assessed as a result of the disallowance of his deduction for such expenses prior to having the issue of deductibility litigated he must bring his action in the Tax Court. The Tax Court has construed the exception in the BAER case so narrowly that it has yet to have before it a taxpayer with a factual situation which it deemed within the exception. However, the taxpayer may appeal an adverse determination by the Tax Court to the Circuit Court of Appeal. Since Mr. Baer was successful in obtaining a deduction for a portion of his property settlement expenses by following this course, many taxpayers have followed his example.[40] On appeal two Circuit Courts have followed the 8th Circuit and reversed the Tax Court's disallowance of taxpayer's deduction of his property settlement expenses to the extent that they were within the exception defined in BAER. Three other Circuits,[41] including the 9th Circuit, have acknowledged the existence of the BAER exception but have upheld the Tax Court either because the taxpayer's factual situation did not come within the exception,[42] or the taxpayer had not made sufficient allocation of the expenses so that the Court could determine if any portion was deductible.[43] It must be noted that one 9th Circuit opinion added as an additional reason for upholding the Tax Court, that the issue whether taxpayer's factual situation is within the BAER exception is an issue of fact and the Circuit Court is bound by the Tax Court's determination of such fact unless it is clearly erroneous.[44] If this position is followed, the chances of the 9th Circuit rejecting the narrow position of the Tax Court are very small. Finally one Circuit, with a very weak factual situation before it, has expressly rejected the BAER exception.[45]

From a reading of the cases it can be concluded that the trend is toward

[37]Followed, *Bowers v. Comm* and *McMurtry v. Comm*, Note 18, *supra*; *Owens v. Comm* and *Patrick et al v. U.S.*, Note 21, *supra*; *Simeon Aller v. Comm*, Note 36, *supra*; *Harry S. Glick v. Comm*, D.C. N.D. Ill., 58-1 USTC Par. 9289 (1958); *James A. Fisher v. Comm*, D.C. W.D. Pa., 58-1 USTC Par. 9296 (1957).

[38]*Patrick et al v. U.S.*, Note 21, *supra*.

[39]Charlotte M. Douglas, Note 28, *supra*; Note 37, *supra*.

[40]Note 37, *supra*; *Tressler v. Comm*, Note 32, *supra*; *Harris v. Comm*, 275 F. 2d 238 (9th Cir. 1960), aff'g D.C.N.D. Calif., 58-1 USTC Par. 9177 (1958).

[41]*Est. of Frank C. Smith v. Comm*, 208 F. 2d 349 (3rd Cir. 1953), aff'g 11 TCM 1167 (1952); *Richardson v. Comm*, (4th Cir.), Note 32, *supra*; *Howard v. Comm*, Note 2, *supra*, *Tressler v. Comm*, Note 32, *supra*, and *Harris v. Comm*, Note 40, *supra*, (9th Cir).

[42]*Richardson v. Comm*, Note 32, *supra*; *Harris v. Comm*, Note 40, *supra*.

[43]*Richardson v. Comm*, and *Tressler v. Comm*, Note 32, *supra*.

[44]*Tressler v. Comm*, Note 32, *supra*. Judge Pope dissented on this point and cited Trust Under the Will of Bingham, Note 26, *supra*, as his authority for the proposition that where there is no factual dispute it is an issue of law.

[45]*Lewis v. Comm*, (2d Cir.) Note 7, *supra*.

complete acceptance of the BAER exception at the Circuit Court level. But as is evident from the decisions in the 9th Circuit[46] this is not to say that reversal is a sure thing even where taxpayer has a strong case. The expense and risk of trying a case in the Tax Court and then having to appeal an almost certain adverse decision to an unsure Circuit Court will probably make it inadvisable to litigate the question of deductibility by way of the Tax Court.

Fortunately the taxpayer has a better way to contest the Treasury's position. He can pay the full amount of the tax assessed and sue for refund in the local District Court or in the Court of Claims.[47] Both the District Courts and the Court of Claims have a history of looking with favor on the taxpayer, and the property settlement expense area is no exception. The only Court of Claim's case dealing with deductibility of property settlement expenses expressly followed the BAER decision and allowed taxpayer's deduction of expenses meeting that case's test for deductibility.[48] There have been four recent District Court decisions dealing with factual situations somewhat similar to that in BAER.[49] All of these cases have held for the taxpayer. One of these decisions was in the District Court for the Southern District of California, Central Division,[50] which is the District Court servicing the Los Angeles area. In this case the Court completely embraced the BAER exception and went much further, by allowing taxpayer to deduct all his legal expenses connected with finalizing a property settlement involving income-producing property which apparently had no special value to the taxpayer aside from its normal and market value.[51] Because of this and other favorable decisions in the District Courts and the favorable precedent now existing in the Court of Claims, it is strongly recommended that the attorney advise any client who desires to litigate the deductibility of property settlement expenses to pay the assessed tax, sue for refund, and litigate the question of deductibility in either of said courts. But regardless of where the action is brought, in presenting his case taxpayer should submit a detailed allocation of his expenses and place special emphasis on the effect wife's settlement claims[52] would have had on his future income earning capacity, and his income-producing motives in resisting said claims.

(b) *Capital expenditures.*

Section 263 of the Code is concise and in pertinent part provides that no deduction shall be allowed for any amounts expended to acquire title to property or increase or better one's

[46] *Howard v. Comm*, Note 2, *supra*; *Tressler v. Comm*, Note 32, *supra*; *Harris v. Comm*, Note 40, *supra*.

[47] IRC Sec. 7401, 7402, 7422. Briefly, the procedure is to file a claim for refund (Form 843) or an amended return within 2 years from the date of payment of the tax or 3 years from the due date of the return, whichever expires later. The taxpayer must then wait 6 months, or until his claim is rejected by the Treasury, whichever comes first, before bringing his action for refund in the District Court or Court of Claims.

[48] *McMurtry v. United States*, Note 18, *supra*.

[49] *Patrick et al. v. United States*, Note 21, *supra*; *Harry S. Glick v. United States, James A. Fisher v. Comm*, and *Simeon Aller v. Comm*, Note 37, *supra*. *Cf Harris v. Comm*, Note 40, *supra*, in which the the District Court for the Northern District of California disallowed husband's deduction of expenses incurred in a trial to determine whether property standing in his name was all separate property, as he claimed, or partially community property, as his wife claimed. Since Baer held deductible only that portion of husband's fee which relates to how husband's liability to his wife is to be satisfied, and did not allow deduction of expenses in determining the amount of liability (capital expenses), the Harris case is not in conflict with the Baer decision.

[50] *Simeon Aller v. Comm*, Note 37, *supra*.

[51] See Note 36, *supra*. The Court in the Aller case found that "In 1952, income from rental and sale of the property covered by the agreement constituted approximately 95% of plaintiff's total income." There was no finding, however, that this property had any special or unique value to the taxpayer other than its market value. See also *Harry S. Glick v. Comm*, Note 37, *supra*, which did not require that the income-producing property have special value.

[52] See Note 31, *supra*.

title to property.[53] The Treasury has taken the position that section 263 also requires expenses incurred in defense of title to be capitalized.[54] No attempt will be made here to discuss the merits of the Treasury's position.[55] Suffice to say that in disallowing any deduction by taxpayer of property settlement expenses the Treasury will add the ground that such expenses are capital in nature to the ground that they are nondeductible personal or family expenses. As stated in connection with the personal expense limitation, litigation will therefore be required to obtain any deduction of these expenses. The Tax Court has held that the Code and regulations prohibit deduction by the wife of her expenes in obtaining property in which she did not own a present interest at the time of the property settlement except to the extent that said expenses are allocable to obtaining property which will be includible in her income when received by her.[56] Since the Tax Court will no doubt continue to uniformly disallow deduction of expenses of property settlements on the ground that they are personal in nature, it seems unnecessary to discuss further

[53]IRC Sec. 263 provides: "(a) General Rule—No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate • • •."

[54]Regs Sections 1.212-1(k) and 1.263(a)-2(c).

[55]The position of the Treasury has been criticized as an incorrect interpretation of section 263 of the Code. The critics take the position that only those expenses of defending title to property which actually increase or better the value of the property are required to be capitalized. See dissenting opinion of Judge Forrester in *Hermann F. Ruoff v. Comm*, 30 TC 204, (1958), majority opinion reversed and dissenting opinion cited with approval, 277 F. 2d 222 (3rd Cir. 1960); Dohan, Note 25, *supra*, At pages 590-96.

[56]Agnes P. Coke, Note 25, *supra*. Taxpayer deducted her legal expenses incurred in a suit against her former husband to "recover" her share of community property which had been concealed by her husband at the time of their property settlement agreement. Pursuant to a compromise of the suit husband placed certain stock in an escrow, to be sold and the cash proceeds distributed half to each spouse. The Tax Court held that the costs of the wife in "recovering" her community property interest, to the extent of her basis for the property, was a capital expense. However, the court held that

the extent to which it will also find the capital expense limitation applicable.

However, as noted above, all is not lost merely because the Tax Court is hostile. An adverse Tax Court decision can be appealed to the Circuit Court, or the Tax Court can be bypassed altogether by paying the assessed tax and suing for refund in the District Court or Court of Claims. How is the capital expense limitation applied by these courts? It seems clear that those courts which refuse to apply the personal expense limitation to taxpayer's property settlement expenses to the extent that they meet the test for deductibility stated in BAER, will not further limit the area of deductibility of said expenses by application of the capital expense provision.[57] No court has yet had any difficulty in allowing the deduction once it has determined that the personal expense limitation was not applicable. The reason for this is that the exception defined in BAER allows the deduction of only those expenses of property settlement which are for determining how an admitted liability can be met without destroying the taxpayer's income production. Since no deduction is allowed under

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the cost of recovering the difference between her basis and the fair market value of said property sold was deductible by her under the regulations (now Regs 1.212-1(k)) which allow the deduction of expenses to recover "investment property and amounts of income which, if and when recovered, must be included in gross income" since upon receipt of the proceeds of the sale in the escrow she would realize capital gains on that amount. It is not felt that the Coke case can be cited as holding that the wife's (or husband's) expenses connected with working out a division of the community property on divorce are capital in nature. Under the facts in Coke, wife had executed a property settlement waiving all rights to property not received by her thereunder. Therefore her suit regarding the concealed property was in the nature of a suit to recover title, and since the question of title was involved the capital expense provision would apply. However, in the case where the community property status of property is agreed upon, the division of the property between the spouses would not involve acquiring, perfecting, or even defending title. In *Charlotte M. Douglas*, Note 28, *supra*, the Tax Court used only the personal expense ground in disallowing wife's property settlement fees in connection with obtaining her half of the community property.

[57]Note 3, *supra*; Note 37, *supra*.

BAER for expenses in determining the amount of liability, the prohibition against deducting expenses for defending or perfecting title will not be applicable.[58] Therefore, the goal is to satisfy the BAER test. If this has been done the courts have not applied the capital expense limitation to further limit the amount to be deducted. Reference is made to subparagraph (a) for a discussion of the courts which are most likely to find a taxpayer has met the requirements for deductibility stated in BAER.

(c) *Section 265 – Expenses related to tax exempt income.*

Section 265 denies a deduction for expenses otherwise allowable which are allocable to producing or collecting tax exempt income. This section will be pertinent to our discussion only where expenses are incurred by the spouses in settling their property rights to insurance proceeds,[59] State or Municipal Bond interest coupons,[60] certain rights to employee death benefits,[61] foreign income,[62] or other items of income specifically exempted from federal income taxation. Property settlement expenses, even though within the BAER exception will not be deductible if related to these items.[63] Where such tax exempt items are involved in the property settlement an allocation[64] of the costs connected therewith must be made to protect taxpayer's right to deduct allowable expenses.[65]

4. Expenses for advice regarding the tax effect of divorce and property division and the filing of tax returns by the divorced parties.

Because of the many important tax aspects of any property settlement and support agreement[66] the attorney must generally spend a substantial amount of time in analysing its tax consequences. Section 212(3) allows the deduction of expenses incurred in connection with the determination of any tax[67] and the Treasury has taken the position that this allows the deduction of all "expenses paid or incurred by a taxpayer for tax counsel."[68] Therefore the amount billed for tax analysis is clearly deductible by the client. The

[58]Note that the wife in a non-community property state will never be able to deduct her property settlement expenses because both the personal expense limitation (husband will not be claiming income-producing property owned by wife and necessary to her ability to earn income and therefore the Baer test for deductibility is not met) and the capital expense limitation (she will be acquiring title to property heretofore not owned by her) apply. This would also be the result in so far as the California wife acquires "Pre 1927 community property" in a property settlement. *Charlotte M. Douglas*, Note 28, *supra*. However, where the wife owns a present and equal interest (with her husband) in income-producing property with a special value it would seem that the wife's expenses in attempting to obtain said property as her share of the settlement would be deductible under the Baer case just as husband's expenses in trying to get it as his share are deductible. The capital expense limitation will not be applied to limit the deduction of the expenses in obtaining the whole interest in said property even though the acquiring party has obtained the other spouse's undivided community property one-half interest, if the division of the whole community property has been equal. See *Osceola H. Davenport*, 12 TCM 856 (1953) and *Ann Y. Oliver*, 8 TCM 403 (1949) holding that an equal division of the community property constitutes a "partition" and does not result in taxable gain to either spouse.

[59]IRC Sec. 101(a)(1) exempts the proceeds from life insurance from taxation except where there has been a "transfer for valuable consideration" as defined in Sec. 101(a)(2). The Tax Court in *Charlotte M. Douglas*, Note 28, *supra*, held that expenses to obtain insurance policies were non-deductible because such policies are not income-producing property. The court did not mention section 265.

[60]IRC Sec. 103(a).

[61]IRC Sec. 101(b).

[62]An individual who is not a citizen and who does not reside in the United States is taxed only upon income from sources within the United States. IRC Sec. 871.

[63]IRC Sec. 265 makes expenses "otherwise allowable" non-deductible if the provisions of Sec. 265 are applicable.

[64]IRC Sec. 265-1.

[65]Regs Sec. 1.265-1(d)(2) provides "The taxpayer *shall* keep such records as will enable him to make the allocations required by this section."

[66]For an excellent discussion of the tax planning connected with divorce and property settlement, see Brawerman, "A Practical Approach to Tax Problems in Divorce and Property Settlement Agreements," 1960 So. Calif. Tax Inst. p. 753.

[67]IRC Sec. 212 provides that "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—* * * (3) in connection with the determination, collection, or refund of any tax."

[68]Regs Sec. 1.212-1(l).

same is true with respect to amounts paid by the client for advice on the correct filing of tax returns during the interlocutory period and after divorce is final.[69] Also, if taxpayer should litigate the deductibility of his expenses incurred in connection with divorce he would be entitled to deduct his expenses in connection with said litigation.[70] The Treasury's acquiescence in the above deductions will be withdrawn, however, where there is an insufficient allocation of expenses between the tax and other services rendered and/or no basis for taxpayer's allocation is presented.

Conclusion

The frequently heard statement that expenses incurred in connection with divorce are not deductible for federal income tax purposes is inaccurate. Clearly the expenses of the wife in obtaining alimony and the expenses of both parties for tax advice are deductible. Depending on the facts and the willingness of the taxpayer to go to court, expenses related to support and property settlement may also be deductible. But the key to these deductions will lie in the adequacy of the allocation of expenses and the proper presentation of the taxpayer's case.

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[69] *Idem.*

[70] *Idem.*

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» » THERE ARE LISTED here the committees of the Los Angeles County Bar Association for the year 1960, and the persons serving on them. A good portion of the hard and useful work which the Association accomplishes is done through these committees. All members of the local Bar owe a vote of gratitude to the persons listed. The names are printed here so that the Bar may know who are the committee members and so that such members may be given a small measure of the recognition they deserve.

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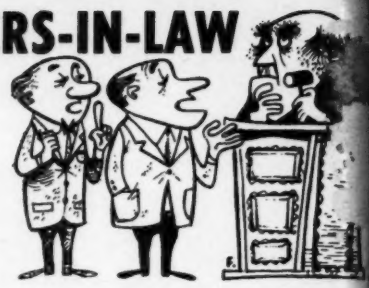

By
GEORGE
HARNAGEL, JR.

FEE TALES

(I) *The Stamp of Genius*

The **Illinois** State Bar Association has proposed new (and higher) minimum fee schedules for adoption by local bar associations in that state. It recommends the use of one schedule in "Lower-Cost Areas," another in "Medium-Cost Areas" and a third in "Higher-Cost Areas". A great many county and other local associations have adopted one or the other of these schedules, with or without change.

Max Weinberg of Quincy, Chairman of the Adams County Bar Association, adopted a unique method of calling to the attention of its members the fact that their costs have risen. He dispatched a letter to each of them inviting attendance at a meeting to consider the new ISBA fee schedules. He sent the letters by first class mail and affixed to each of them a two-cent stamp!

(II) *The Meat of the Matter*

Cody Fowler, former president of the ABA, once informed this department that he suggests to his younger partners, whenever they have a fee to fix, to first go out and buy themselves a good steak dinner.

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The University of **Texas** Law School presents an annual comedy show in which faculty members, students and their wives participate. It is called *"The Assault and Flattery Revue."*

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Tongue-Twisters from Canada (II)

Fifteen minutes after *Tongue-Twisters From Canada*[1] had been painstakingly proof-read, we received a phone call from Steve Farrand who said he liked the Firm Fun series, but that for a real field day in "euphonious" firm names there was no place like the Canadian section of the Martindale-Hubbell Law Directory. Here are a few he rolled off his tongue and later sent along in a note:

Alberta

CHAMBERS, MIGHT, SAUCER, PEACOCK, BLACK & GAIN.

FENERTY, FENERTY, MCGILLIVRAY, ROBERTSON, PROWSE, BRENNAN & FRASER.

MACCLEOD, MCDERMID, DIXON, BURNS, MCCOLOUGH, LOVE & LEITCH.

MCCUAIG, MCCUAIG, DESROCHERS, BECKINGHAM & MACDONALD.

MILNER, STEER, DYDE, MASSIE, LAYTON, CREGAN & MACDONNELL.

Ontario

MCMILLAN, BINCH, STUART, BERRY, DUNN, CORRIGAN & HOWLAND.

Quebec

COMMON, HOWARD, CATE, OGILVY, BISHOP, COPE, PORTEOUS & HANSARD.

SENECAL, TURNBULL, MITCHELL, STAIRS, CULVER, KIERANS & CLAXTON.

[1]The LOS ANGELES BAR BULLETIN, Vol. 35, No. 12, p. 20, October, 1960.